

U.S. Market Watch

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OVERVIEW

- The dramatic decision by U.S. Treasury Secretary Paulson to take Fannie Mae and Freddie Mac into conservatorship, once again highlighted the extreme event risk hanging over financial markets these days. The move stopped just short of a full scale nationalization, but makes tax payer money available to absorb losses at the two U.S. mortgage giants. Both companies had been brought to their knees by the erosion of their capital base – the safety cushion against losses – which was much thinner than those of banks and brokers to begin with.
- The Paulson plan includes a liquidity backstop to prevent near term funding problems, should investors be unwilling to refinance maturing Fannie Mae and Freddie Mac debt. It also includes a conditional capital infusion of up to US \$100 billion for each company and a facility for the U.S. Treasury Department to purchase mortgage-backed-securities issued by Fannie Mae and Freddie Mac.
- Financial markets initially greeted the plan with great euphoria, but the optimism didn't last long. Yes, a major downside risk – the insolvency of one or both government sponsored enterprises (GSEs) – has been averted, but the rest of the financial sector still needs additional capital, which is increasingly difficult to raise.
- U.S. stock markets posted another small gain in August, but started September with a much weaker tone. 10-year Treasury bonds rallied sharply and yields fell below 3.6% for the first time in five months. The U.S. dollar, on the other hand, continued to gain against most other currencies, especially the Euro and British Pound, which suffered their worst monthly declines in 15 and 16 years respectively.

ECONOMY

- Meanwhile in the real economy, not much has changed, which is probably good news. Taking a step back, it is now clear that U.S. domestic demand (i.e. consumption, business investment and government spending) were in, or near, a recession at the turn of last year. However, the latest GDP report for the second quarter confirmed that the rebound in economic growth was helped, in no small part, by the Economic Stimulus Package that supported consumer and business spending. The actual GDP growth rate of 3.3% was greatly exaggerated by a sharp drop in imports, which are subtracted from growth, but domestic demand bounced back to 1.5%, which is about the rate of growth we expect the overall economy can attain in the second half.
- U.S. labor markets deteriorated more than expected in August, but the job losses were more concentrated than in previous months, coming mainly from the auto industry. The sharp increase in the unemployment rate was driven by more people looking for work, rather than an acceleration of the pace of job losses.
- Be that as it may, it is obvious that the current sluggish growth pace is insufficient to generate enough new jobs for the growing number of people looking for work. The employment report also hinted at faster wage & salary growth, which, along with falling energy prices and left-over dollars from the rebate checks, should support consumer spending.

POLICY

- The Federal Reserve remains very much on the sidelines. The financial market crisis renders monetary policy largely ineffective as a tool to stimulate economic growth. The introduction of various facilities to provide liquidity to the banking sector has, thus far, prevented a more serious meltdown, but has not yet cured the systemic risks emanating from the financial sector.
- Most of the recent speeches by Fed officials, and the minutes of the last FOMC meeting, indicate a continued progression towards an inflation and tightening bias, which is consistent with our forecast of a rate increase by the end of the year. The Fed is likely to wait for the current crisis surrounding Fannie Mae and Freddie Mac to abate before starting to prepare investors for a hike in interest rates, but we expect broadening inflation pressures will take over as the dominant policy driver later in the year.
- The political party conventions and the announcement of running mates for Presidential Candidates Obama and McCain put the spotlight firmly on the upcoming elections, which are less than two months away.
- Meanwhile, the recent war between Russia and Georgia is another reminder of the geopolitical uncertainty that exists in the rest of the world. Just as the U.S. involvement in Iraq is drawing to a close, unrest in Georgia, Pakistan and the constant rumblings of an imminent attack on Iran remind us of political event risk that could potentially spook investor confidence. Both events increase uncertainty with regards to the near term political backdrop and are likely postpone a more meaningful rebound in investors' risk appetite.

INVESTMENT OUTLOOK

- Our overall investment strategy remains unchanged. We continue to favor bonds over equities in our balanced strategies and prefer U.S. stocks over international equities. In our fixed income funds, we maintain a neutral duration bias with weak growth and the financial market crisis pushing yields lower, while inflation concerns are pulling in the other direction. In our credit strategies we are looking to increase our underweight in international bonds and maintain a marginal overweight in high yield and investment grade bonds, where historically wide yield spreads offer adequate protection for the underlying credit risks.
- We believe a convincing catalyst for a broader rebound in risk appetite is still lacking. Forward looking indicators suggest that the housing market is getting closer to finding a bottom, but foreclosures and delinquencies are still rising, indicating that pressures on bank balance sheets still remain. A sustained rally in equities or credit spreads remains unlikely until the banking sector starts to pull out of the current crisis.

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